

# Philippine Economic *Outlook*

SEPTEMBER 1999

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## Introduction



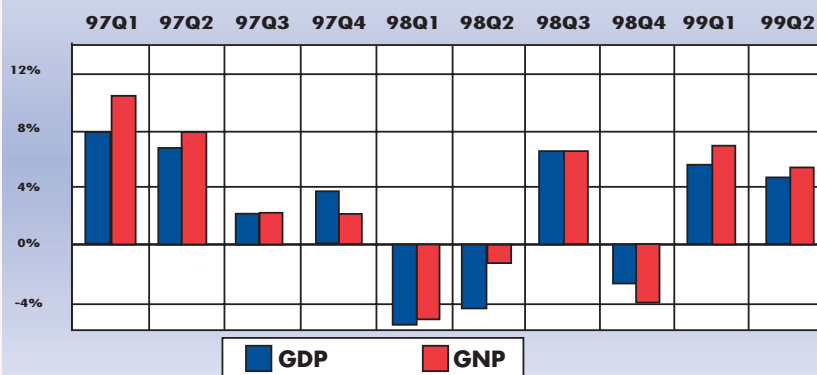
With its domestic economy growing at a 2.4% clip for the first half of 1999 (year-on-year), the Philippines has emerged from the worst effects of the Asian financial crisis. In fact, the 1998 economic slump was only slightly worsened by the regional crisis; its root was the El-Niño induced drought which cut agricultural output by 6.6% in 1998. Based on the promising first half numbers, we have revised our 1999 GDP forecast upwards from our earlier estimate of 1.6-2.4%. We now believe GDP could rise by 2.7-3.1% for the whole year. Having said that, much still remains to be done to encourage further stable growth in the Philippine economy. Persistent structural weaknesses must be addressed, fiscal imbalances corrected, and perhaps most importantly, the country must continue to prepare itself to compete effectively in a rapidly globalizing economy.

The biggest difference between the Philippines and many of its neighbors during the Asian financial crisis has been the strength and stability of the banking sector. Past crises and economic adversity (such as the 1980's debt crisis) had caused both the private and public sectors of the Philippine economy to approach foreign borrowings with caution. As a result, more than 80% of the Philippines' foreign debt stock is medium- to long-term, and corporate foreign debt is modest by regional standards. Further, most foreign currency deposits in the Philippines are owned by Philippine nationals, and are therefore less subject to currency flight. Finally, much of the foreign currency debt is owed by firms that either earn foreign currency or that have price adjustment mechanisms (oil firms, utilities) to cover exchange rate fluctuations. The resilience of the financial sector through the crisis also can be attributed to reforms introduced throughout the 1990's to strengthen capital markets and bank supervision. While much remains to be done, the Philippine banking system remains sound and well-capitalized, despite rising bad debts.

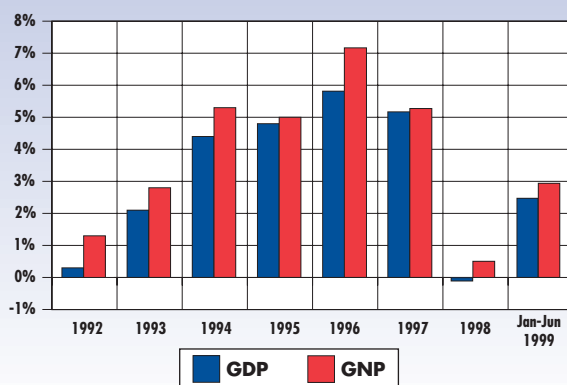
Seasonally adjusted quarter-on-quarter GDP figures show the Philippine economy bottomed out in the second quarter of 1998, with a drop of 1.7% from the final quarter of 1997. Growth returned in the third quarter of 1998 (1.6% over the previous quarter), but poor weather in the fourth quarter of 1998 cut agricultural production and, therefore, GDP (down 0.7%). Both the first and second quarters of 1999 saw GDP growth on a quarter to quarter basis (1.4% and 1.2%, respectively), led greatly by agriculture. The government has worked aggressively to reduce interest rates, with 91-day T-bill rates dropping from more than 15% in September 1998 to less than 10% currently. Rates have bottomed out for now, but credit growth remains lethargic as lenders (and borrowers) still want more proof the recovery has come. The peso has stabilized in the range of P39-40 to US\$1.00, fluctuating mostly on regional news and domestic rumors. Earlier in the year the stock market had recovered to above the 2500 level, but has since sunk back to the 2000-2100 range on thin trading and poor corporate earnings. Inflation continues to slow, mostly as a result of agricultural recovery. Weak fiscal performance is the most significant challenge for the government to tackle in the medium term.

The Philippine economy was widely regarded as the regional economy least affected by the Asian financial crisis. (It was also one of the regional economies least affected by the Asian Boom of the 1980s and early 1990s.) The Philippines has the opportunity to continue the economic reforms that enabled it to

**QTR.-to- QTR. GDP & GNP GROWTH**  
Seasonally Adjusted Annualized Rates



## REAL YEAR-TO-YEAR GDP & GNP GROWTH



weather the crisis well and to build a solid foundation for future, more rapid and sustainable economic growth. Key issues include:

- Continuing with trade and tariff reforms toward freer markets;
- Removing barriers to foreign investment;
- Improving agricultural productivity and infrastructure in rural areas;
- Restoring fiscal balance by improving tax administration and rationalizing a bloated bureaucracy;
- Continuing liberalization in financial markets, electric power, and telecommunications;
- Continuing to reduce the government's direct role in the economy through privatization; and
- Improving transparency and accountability in government.

## Output and Inflation

Real Gross Domestic Product grew year-on-year during the first and second quarters of 1999, resulting in a cumulative first semester expansion of 2.4% over the first half of 1998. First semester Gross National Product (GNP) expanded by 2.9% over its comparable 1998 level, partly on the continued strength of overseas workers' remittances. Seasonally adjusted quarterly estimates (which do not show much detail) show real GDP and GNP increasing quarter-on-quarter in both the first and second quarters, giving strong confirmation that the brief 1998 recession has ended.

Agriculture, while widely expected to begin its recovery from 1998's drought-induced losses, far exceeded expectations. First semester agricultural output grew 6.6% year-on-year, almost twice the rate the government forecast for 1999. That strong rebound and the relatively resilient service sector spurred GDP growth on the supply side. The industrial sector's 1.4% decline — reflecting stagnant manufacturing output and the continued slump in construction activity — capped the economy's expansion. On the demand side, personal consumption remains the main engine of growth. Consumer spending has grown more slowly since the Asian crisis, just keeping ahead of population growth (2.3% annually), leaving spending levels intact in per capita terms. Government spending also provided some demand-side stimulus. Government consumption expanded 6.9%, contrasting with the 3.8% decline posted during the first semester of 1998. Without the robust 27% expansion in public construction spending, fixed capital formation (down 6.5%) would have declined more steeply year-on-year because of the 20% drop in private sector construction, the weak demand for durable equipment (down 7.9%) and inventory drawdowns.

Improved weather conditions have eased food supply and prices. After hitting an Asian crisis high of 11.6% in January 1999, the twelve-month inflation rate has since eased markedly (5.5% in August). Year-on-year inflation averaged 7.7% during the first eight months of the year, below the lower end of the government's 8-9% target for the full year. More stable food prices have tempered the effect of upward fuel price adjustments resulting from increases in world crude costs. Heavy August rains and flooding have raised some concern over the possible impact on inflation from agricultural prices in coming months. Renewed foreign exchange pressures and increases in world crude prices have also added to concerns that the Philippine inflation rate has bottomed out. There could be upward price pressures in coming months, but average year-on-year inflation appears likely to remain at the lower end of the government's forecast.

After declining by 0.5% in 1998, we expect full-year 1999 GDP to grow by 2.7-3.1% year-on-year. This represents an upward revision of our earlier 1.6-2.4% GDP growth forecast, mainly because of agriculture's stronger-than-expected recovery. Had agricultural output grown by the government's 3.5% best-case estimate, first semester GDP would have expanded 1.8%, nearer the lower end of our earlier forecast range. Agriculture's performance is expected to impact on overall demand through improvements in rural incomes and employment. Industrial sector output has, thus far, lagged behind government planners' expectations despite the sharp expansion in public sector construction activity. Although second quarter statistics showed emerging signs of a recovery in manufacturing, overall industrial sector recovery over the short-term is likely to be limited by the continued slump in private construction and in construction-related manufacturing industries. Beyond the short-term, a sustained recovery will depend on reviving business confidence which, in turn, will require clear and consistent government support for continued liberalization and market-based reforms.

## Labor and Employment

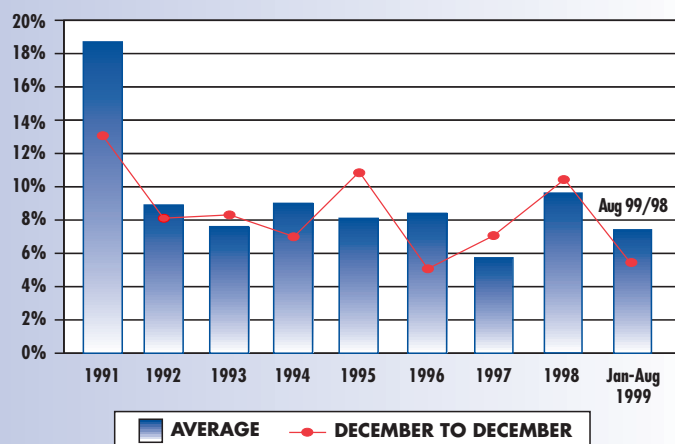
The economic slowdown pushed the Philippines' 1998 full-year unemployment rate (computed as the average of quarterly surveys) to 10.1%, with the drought-hit agricultural sector accounting for the majority of job losses last year. Agriculture's recovery is now easing the pressures on the urban job market from economic migrants, making up for the continued loss of jobs in the industrial sector. However, statistics show that the overall expansion in the number of employed persons reflects the growth of "unpaid family workers", particularly in agriculture. In the Philippines, agriculture accounts for 40% of jobs, but only 20% of GDP, indicating a pressing need to boost agricultural productivity and incomes. Underemployment has also risen to 22.4% (average of the three most recent quarterly surveys) of the employed, from less than 21.1% in the previous year. Moreover, the Department of Labor estimates that the "visibly underemployed" (those working less than the 40-hour regular workweek) constitute more than half of the underemployed.

Government employment policies have focused on boosting investment — both foreign and domestic — to generate jobs. Job losses and plant closures in the past few years, particularly recent moves by some multinational firms to restructure or close plants in the Philippines, has led Philippine policy makers to consider revisions to the labor code to make it more flexible.

## Financial Markets

Domestic interest rates may have bottomed out over the short-term, following intensified government efforts to ease domestic liquidity and bring down key rates during the first half of 1999. Between January and June 1999, the BSP cut required reserves by a total of five percentage points to 12%, and reduced its key

## CPI YEAR-TO-YEAR CHANGE



\* Base Year 1994 beginning 1997 (revised series based on results of Government's 1994 Family Income and Expenditure Survey). Base Year 1988 for data prior to 1997.

overnight borrowing and lending rates by a total of 4.38 percentage points (to 9% and 11%, respectively). Treasury Bill rates, which averaged close to 14% for all maturities at the beginning of the year, had softened to a weighted average rate of 9.15% by the end of June. At the end of the first semester, reserve requirements, key BSP rates and T-bill rates had been brought down to below pre-crisis levels.

Rafael Buenaventura, previously CEO of the Philippine Commercial and Industrial (PCI) Bank after a 24-year career with Citibank, assumed office in July as Governor of Bangko Sentral. The new Governor has kept key BSP rates unchanged but has expressed concern that narrowing differentials between domestic and foreign yields and possible increases in inflation could threaten the peso's stability. The Treasury openly took the opposite position by rejecting most bids in its weekly T-bill auctions in order to push rates lower. The Treasury also lowered the volume offered at its T-bill auctions three times this year, from P5.5 billion to P4 billion. The strategy was effective in the first half of 1999 but became unsustainable, especially after the U.S. Federal Reserve raised the federal funds rate in August for the second time this year. Weighted average T-bill rates for all maturities rose from 8.8% to 9.1% between August's first and last weekly auctions. The strong demand from banks for the 91-day bills has helped temper upward pressure at the short end of the yield curve. There has been little appetite for the government's longer-term offerings, at rates that the Treasury has been willing to accept. Due to the weak demand for the longer-term T-bill maturities, the Treasury, beginning September, temporarily reduced its weekly offered volume of 181 and 364-day bills by P500 million each and doubled its offered volume of 91-day bills to P2 billion. The government insists it has enough cash and other funding sources, but its problematic fiscal situation may have affected its credibility to continue rejecting banks' bids, drawing it into a "waiting game." Depending on developments in the foreign exchange and inflation fronts, rates now appear likely to move sideways — with a stronger upward bias — over the coming months.

Credit growth remains weak despite government efforts to encourage lending to the private sector. In addition to cutting reserve requirements and slashing its key rates, the BSP exempted bank loans granted after March 1999 from a 2% general loan loss provision (a crisis-related response implemented in stages beginning October 1998) in a further effort to reduce intermediation costs and stimulate lending. In mid-August, the BSP announced that it would pay less than the published rate of 9% for overnight placements beyond a certain amount — a tactic designed to reduce the attractiveness of risk-free lending. In one of his earliest speeches as BSP Governor, Buenaventura likened monetary policy to a "string," which "can be used for pulling back, but not for pushing forward." Banks expect credit revival to be a gradual process, expecting, at most, modest single-digit growth over 1998 as the year progresses.

In June 1999, the Bankers Association of the Philippines (BAP) lifted a "gentleman's agreement" — adopted shortly after the crisis erupted — which capped loan spreads to 150 basis points (prime) and 650 basis points (non-prime) above 91-day T-bill rates. Since the agreement was lifted, the published rates for new loans generally have not deviated significantly from the previous spreads over the 91-day T-bills because of a liquid financial system. Commercial banks' quoted prime rates for new loans — which were over 30% in early 1998 — softened to under 17% in late 1998, and to less than 11.5% as of end-August 1999. May and June saw modest month-on-month expansions in outstanding commercial bank loans, but credits remain down year-on-year. After growing by over 40% in 1996 and by 29% in 1997, outstanding commercial bank loans ended 1998 lower by 1.9% from the end of 1997. Loans as of June 1999 were 5.6% lower than at the end of June 1998.

The measured ratio of commercial banks' non-performing loans (NPLs) to total loans continued increasing between December 1998 (10.4%) and May 1999 (14.5%, the highest thus far since the Asian crisis). Latest estimates show the NPL ratio declining to 13.1% in June, reflecting loan restructuring, foreclosures and repayment. Banks claim they have seen a gradual improvement in the quality of loan portfolios due to conservative lending policies and lower interest rates. Restructured loans accounted for 3.8% of total bank loans as of end-June 1999, more than four times the mid-1997 ratio. Loan loss provisions stood at 4.8% of total loans, from 1.3% before the Asian crisis. Banking industry leaders do not yet discount a second — albeit smaller wave — of loan defaults, and are not yet quite ready to conclude that NPLs have peaked. Even a non-performing loan ratio of 15% or a bit higher would not threaten the soundness of the banking system. Partly because of an ongoing, staggered build-up in minimum capitalization requirements, the banking system has remained generally resilient despite rising levels of bad debts. Latest estimates place the banking system's capital adequacy ratio at 17.9%, up from 16% as of end-1998 and well above the BSP's required 10% level. The crisis has so far claimed only one small

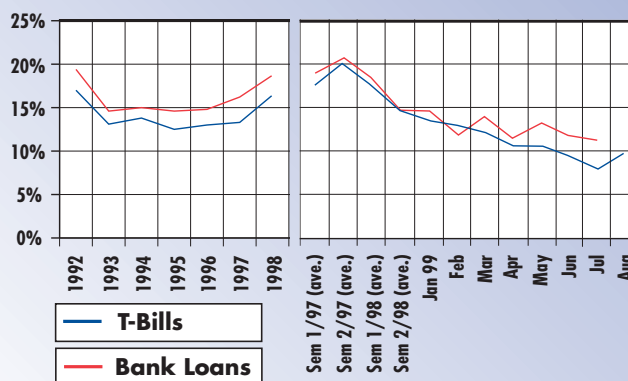
commercial bank. The approximately 900 smaller thrift and rural banks (which account for only 10% of total banking system assets) have been more severely affected, and more than 40 have been taken over by the Philippine Deposit Insurance Corporation since the Asian crisis erupted. The closed banks constitute less than one-half of one percent of the total resources of the Philippine banking system.

To improve the banking system's resilience to further shocks, the BSP has worked to strengthen prudential safeguards. Measures enacted so far include: lowering the limit on real estate loans (from 30% to 20% of loan portfolio); requiring a 30% liquidity cover for all foreign exchange liabilities of foreign currency deposit units; imposing stricter specific loan loss provisioning requirements; phasing in a 2% general loan loss provision (for loans granted before April 1999); and specifying a stricter definition for past due loans. More recent reforms include expanding disclosure requirements for publicly listed banks; specifying tighter criteria for banks seeking to expand branch networks; and tightening loan restructuring provisions to prevent banks from indiscriminately restructuring accounts to window-dress NPL ratios.

The Bangko Sentral is also actively encouraging greater consolidation among banks and other financial intermediaries to develop stronger financial institutions better able to cope with the opportunities, as well as challenges, of accelerating globalization. In March 1998, the BSP announced a phased increase in banks' minimum capital requirements through the year 2000, following through with stiffer penalties and a "prompt corrective action program" for capital-deficient banking institutions later that year. An August 1998 BSP circular extended incentives for banks merging or consolidating. Shortly after becoming BSP Governor, Buenaventura strongly hinted that the BSP was considering another round of minimum capital hikes. At least five agreements for mergers or acquisitions among commercial banks have been formally announced since the beginning of the year and are in various stages of completion — including a merger between two of the country's largest commercial banks, Philippine Commercial and Industrial Bank with Equitable Banking Corporation. The other banks which have announced merger plans are Prudential Bank and Pilipinas Bank; Asian Bank and the Philippine Bank of Communications; Bank of Commerce and Traders Royal Bank; and Philippine Banking Corporation and Global Business Bank. These are not likely to be the last, with a number of other banks reportedly exploring potential partnerships. In August 1999, BSP Governor Buenaventura announced that the BSP was temporarily suspending granting licenses to new banks, a further measure to encourage buy-ins into existing institutions and to promote more mergers among existing players.

The Philippine stock market staged a comeback from its Asian crisis low point but, like other markets in the region, remains vulnerable to reversals. The Philippine Stock Price Index (Phisix) closed 1998 at 1969, up 5.4% from the end of 1997 and up 81% from the six-year low it recorded in September 1998. The Phisix remained above the 2000 level from March to August this year, but not without intermittent bouts with regional and domestic uncertainties and negative sentiment. The Phisix broke 2500 in early May and, following some ups and downs, broke the 2600 mark in early July. The market then gave way to another wave of uncertainties. Political jitters triggered by press freedom issues and division over President Estrada's proposal to amend the 1987

### AVERAGE DOMESTIC INTEREST RATES



\*As recorded by Bangko Sentral, lending rate refers to ratio of actual interest income to outstanding loans, rather than to banks' quoted rates for new loans. T-Bill rate is weighted average for all maturities.

Philippine constitution contributed to downward pressure. The Phisix closed at 2087 on August 17 (its lowest close since early April this year), before inching up to close at 2174 by month's end. Daily trading volumes began recovering to the P3 billion pre-crisis average starting April 1999, but the market remains thin and narrow, prone to speculation, and dominated by a few listed stocks. The market's troubles have severely affected the many small brokerage firms. More than twenty firms are inactive or have suspended operations.

## Fiscal Performance

Sustaining fiscal viability remains the administration's most pressing challenge in its bid to break completely from the boom-and-bust growth pattern of the past. The national government incurred a fiscal deficit of nearly P50 billion in 1998 (1.8% of GNP), reversing four straight years of surpluses from 1994 through 1997. The consolidated public sector deficit (CPSD) — which includes the Bangko Sentral, government-controlled corporations, and government-administered social security agencies — ended 1998 at P83.2 billion (3% of GNP), more than three times 1997's CPSD. With the encouragement of the International Monetary Fund, the 1999 government budget calls for a larger national government deficit of P68.4 billion (2.2% of GNP) and a consolidated public sector deficit of up to P97 billion (3.1% of GNP) to help stimulate economic expansion. The government's medium-term fiscal policy projects gradually declining deficits, beginning in 2000, and a balanced consolidated public sector budget in 2003.

The national government's 1999 fiscal program is based on a 13% (P59.4 billion) expansion in national government revenues and a 15% (P77.8 billion) expansion in expenditures. Difficulties have already begun to emerge. Revenue collections during the first seven months of 1999 were P15.6 billion short of target. Non-tax inflows, P4 billion larger than expected, only partially offset a tax collection shortfall of nearly P20 billion — which mainly reflected weak internal revenue collections. Furthermore, the government's 1999 budget included P7 to P8 billion from new measures that require congressional approval, none of which have been passed to date. The national government realized nearly P7 billion in savings on expenditures which it attributed to lower-than-programmed interest payments and some "overestimation" of the amount required to settle accounts payable from prior years, but the situation remains problematic. Despite lower disbursements, the P60.5 billion January-July national government deficit exceeded the government's target by nearly P7 billion.

A number of government officials have since stated that the national government could exceed its deficit ceiling by P5-10 billion unless expenditures are held back. Once again, the government faces unpalatable choices: tightening the rein on spending (at the expense of higher economic growth) or allowing the deficit to widen (which could exert upward pressure on domestic interest rates). Owing to the better-than-anticipated performance of other government agen-

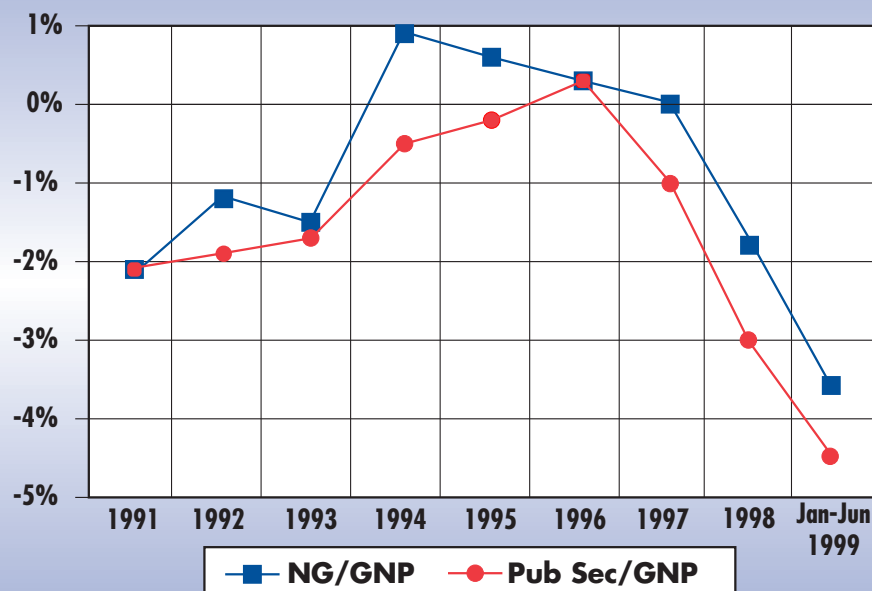
cies and corporations, preliminary estimates indicate that the first semester CPSD managed to track the six-month P64.3 billion deficit target despite the national government's increased fiscal gap.

President Estrada has submitted to Congress his year 2000 budget proposal, which targets a more modest expansion in national government spending (9% — barely above the inflation forecast) and higher growth (16%) for revenues. The budget would reduce the fiscal deficit to P40 billion. That deficit target hinges heavily on tax collections rising by 17.6%, based on what some economists consider optimistic macroeconomic projections (for example, 5.3-5.9% real GNP growth). The revenue target also assumes an improvement in "tax effort" (i.e., the ratio of revenues to GNP), despite long-standing weaknesses in tax collection and administration.

One study estimated that about half of value added and personal income taxes, and about 40% of corporate income taxes, escape collection. The government has had to rely on new ad-hoc revenue measures to make up for weak collection and enforcement (among them, higher taxes on stock transactions, a minimum 3% tariff, increases in government fees and charges, and an expanded value added tax). A Comprehensive Tax Reform Program (CTRP) — completed in late 1997 — was intended to improve the longer-term sustainability of government finances through reforms in excise and income taxation. However, it has not significantly widened the tax base or improved tax enforcement. Short-term measures such as the ERAP program (exempting taxpayers from audits as long as their tax payments in 1999 exceed 1998 payments by 20%) and a proposed tax amnesty do not send the appropriate signal that the government is serious about improving collection efforts. Major tax cases have languished in the courts.

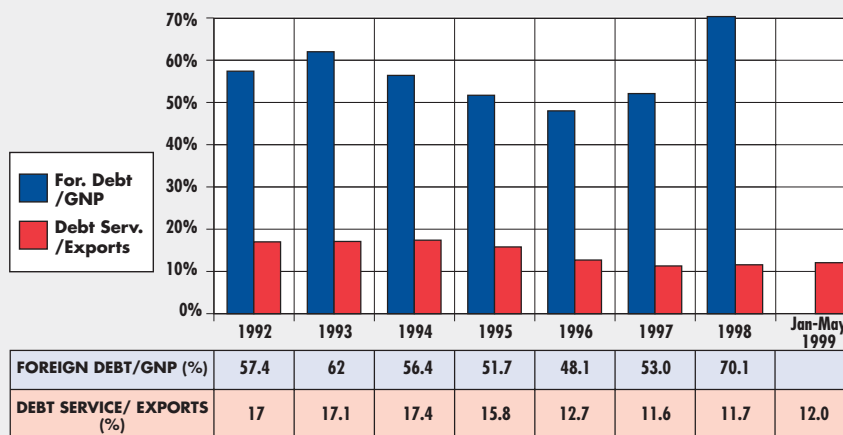
Efforts to contain expenditures are hampered by the large share (over 70%) of "non-discretionary" expenditures such as payroll costs, interest payments and mandated transfers to local government units. Personnel-related costs alone constitute about a third of national government expenditures. Combined with weak revenues, this means that the government simply does not have the resources to seriously address the nation's many needs in health care, education and infrastructure. The proposed 2000 budget includes provisions for government "re-engineering," which will require strong political will. Efforts to restructure the bloated bureaucracy could be politically difficult under the Estrada administration's much-emphasized pro-poor agenda and in an environment of high unemployment. Government-controlled companies also impose a heavy load on public sector finances, making it imperative for the government to forge ahead with the privatization of financially burdened companies providing essential services. Water supply has already been privatized. A power sector reform bill pending before Congress would restructure the electricity industry and privatize the government-owned National Power Corporation.

**PUBLIC SECTOR & NG SURPLUS/DEFICIT AS % OF GNP**





## FOREIGN DEBT RATIOS



## Foreign Debt and Debt Service

The government is relying heavily on foreign financing to fund the 1999 budget as part of its overall strategy to keep pressure off domestic interest rates. The national government has already issued about \$1.6 billion worth of bonds in international capital markets since the beginning of the year, including Asia's first Euro-denominated bond sovereign issue (\$383 million). Bangko Sentral has also raised \$700 million from the international capital markets as of mid-August, both to widen its international reserve cushion and to retire some of its short-term obligations.

The Philippines technically graduated from over three decades of International Monetary Fund (IMF) supervision in March 1998, but promptly entered into a two-year "precautionary" arrangement due to the regional currency crisis. The Estrada administration converted this program to a regular \$1.4 billion standby agreement in August 1998. The government drew \$755 million from the IMF standby facility between November 1998 and July 1999.

The Philippines also continues to receive financial assistance from other bilateral and multilateral creditors, such as the Asian Development Bank, the World Bank, and Japan's Overseas Economic Cooperation Fund. The 22nd Consultative Group meeting held in Tokyo in March 1999 yielded an estimated \$4.5 billion in pledges from multilateral and bilateral donors — including some \$1.9 billion under the Miyazawa fund framework (from which the government has already drawn \$925 million). The government also hopes to tap \$1 billion or more of Japan's recently created Obuchi fund, although we understand that Japan has so far offered the Philippines only \$600 million. The Philippines has a very poor record implementing development assistance projects, an issue raised by many donors at the Consultative Group meeting. The Department of Budget and Management has created a "one-stop shop" for donor-funded projects in an effort to accelerate implementation.

The Philippines' recorded foreign debt was \$48.6 billion as of end-March 1999, up by \$820 million from the end of 1998. External obligations of the private non-bank sector — estimated at \$12.2 billion (22% of outstanding external liabilities) — comprise a much more modest share of the foreign debt stock compared with the Philippines' more distressed neighbors. Concessional loans from bilateral and multilateral creditors account for 51% of the outstanding foreign debt level. The bias for medium- to long-term maturities — over 86% of obligations — has helped the Philippines avoid the serious difficulties experienced by neighboring economies. Observers nevertheless emphasize that foreign borrowings should be carefully managed to avoid maturities bunching up in later years.

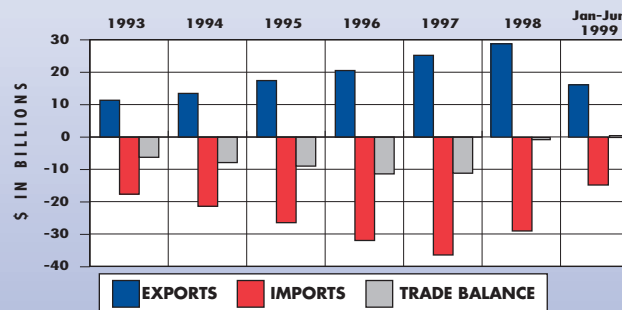
Although the foreign debt stock has been increasing, foreign debt servicing — which peaked at close to 40% of merchandise and service export receipts during the early 1980s — is no longer a severe problem. Debt service payments equaled 12% of goods and services exports during the first five months of 1999. However, the debt service crisis of the 1980s and the Asian financial crisis painfully demonstrated that continued heavy reliance on external borrowing is not a viable long-term strategy. Furthermore, the Philippines' narrow export base makes the country especially vulnerable to unexpected reversals in export markets.

## Merchandise Trade and Balance of Payments

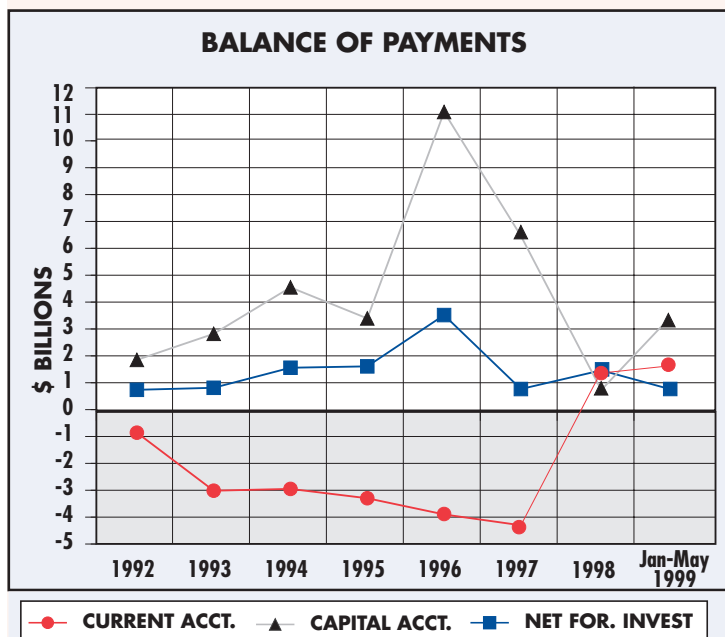
Export growth continues at a double-digit rate, although more slowly than the 23% growth in 1997. Merchandise exports grew 17% in 1998 (over 1997) — the strongest growth rate in any Asian country that year. Export growth has been increasingly concentrated in electronic equipment and peripherals, which grew 20% in the first half of 1999, accounting for over 85% of overall export growth. The sector now generates nearly two-thirds of export receipts and the Philippines overtook Malaysia in 1998 as Southeast Asia's leading exporter of semiconductor devices. Exports in the first six months of 1999 grew a further 13.6%, based on preliminary statistics, with the electronics sector still accounting for the great bulk of the increase.

Imports continue to decline from prior-year levels, reflecting both the peso's depreciation and the drop in capital spending. Total imports in the first half of 1999 dropped 0.9% from 1998's level due to declines in imports of capital goods and petroleum products. The 13.3% year-on-year decline in the Philippines' first semester oil import bill reflected lower import volumes. Average prices of oil products brought in during the first semester were about the same as in the first half of 1998. Imports of raw/intermediate materials and consumer goods increased, due to the heavy dependence of the electronics sector on imported components and to replenishment of drawn-down inventory levels. Although first semester imports declined 0.9% from 1998, monthly statistics show total imports up year-on-year during the months of March, April and June. Cumulative imports during those three months rose 8% from their comparable 1998 level, driven by a 28% surge in materials and accessories required by the country's import-dependent electronics export industry. Current import levels, however, do not yet indicate a pick-up in domestic manufacturing.

## MERCHANDISE TRADE



EXPORTS	11.375	13.483	17.447	20.543	25.228	29.496	15.803
IMPORTS	-17.597	-21.333	-26.391	-31.885	-36.355	-29.524	-15.107
TRADE SURP/DEFICIT	-6.222	-7.850	-8.944	-11.342	-11.127	-0.028	0.696



The combination of strong export growth and weak imports narrowed the merchandise trade deficit to \$28 million in 1998. A positive services account (mainly due to remittances from overseas workers) produced the Philippines' first current account surplus in twelve years in 1998. The first half of 1999 saw the Philippines record a merchandise trade surplus of \$696 million, making it likely that the country will have a full-year trade surplus for the first time in 25 years.

Preliminary estimates — computed from the change in BSP net international reserves — placed the country's overall BOP position at a surplus of \$2.8 billion as of July 1999, double 1998's seven-month level and near the \$3.2 billion full-year target. Available statistics point to a merchandise trade surplus and larger loan inflows as the major sources of the expansion. Statistics through May showed the current account \$1.9 billion in the black.

## Foreign Exchange Rate and International Reserves

The peso consistently traded above the P40/\$ mark from November 1998 to August 1999 but, like the equities market, the foreign exchange market remains prone to quick reversals in sentiment. Opening the New Year at P38.90/\$, the peso strengthened to between P37.50 to P38/\$ in May and June. By July, however, renewed regional jitters, a narrowing differential between domestic and foreign interest rates, and the expectation of higher U.S. interest rates combined to weaken the peso. By August, the peso was trading below P39/\$ and flirting with the P40/\$ level. Bangko Sentral Governor Rafael Buenaventura has said in various fora that he generally expected the peso to trade in the P38-40 band, although there could be occasional aberrations due to intermittent volatility in regional markets. Overall, he noted that a wide BOP surplus and a healthy international reserve cushion did not justify the peso falling below the P40/\$ level.

The BSP has been building up its international reserve cushion after reserves dipped to an end-1997 level of P8.8 billion (a level barely adequate for 1.9 months worth of goods and services imports). BSP international reserves — which the Bangko Sentral built-up to \$10.8 billion by the end of 1998 (3 months worth of imports) — had risen further to a record month-end high of nearly \$14 billion as of end-July 1999 (more than 4 months worth of imports). That international reserve cushion is also about double the estimated level of the Philippines' short-term foreign debt. The BSP's measurement of adequacy of reserves in terms of months of import cover probably understates the strength of the Philippines' position. The changing nature of Philippine trade and the

growth of electronics exports has increased imports of components for processing and re-export. These imports are "self-financing" in that they enter only in response to export orders that will pay for them.

The expansion of international reserves since the beginning of the year reflected foreign loan proceeds and BSP net purchases of foreign exchange. Considered "secondary reserves," the Bangko Sentral also estimated that banks' foreign currency deposit units (FCDUs) had about \$15 billion in deposits as of mid-1999, 86% of which represented deposits of Philippine residents.

## Y2K Update

The Government of the Philippines and several key sectors of the economy are reliant on computerized systems. Awareness of the Y2K problem is high in nearly all sectors of the Philippine economy. The national government and several industries have developed plans; but remediation is behind schedule and underfunded. Provincial and local governments are not as dependent on computerized systems as highly urbanized areas.

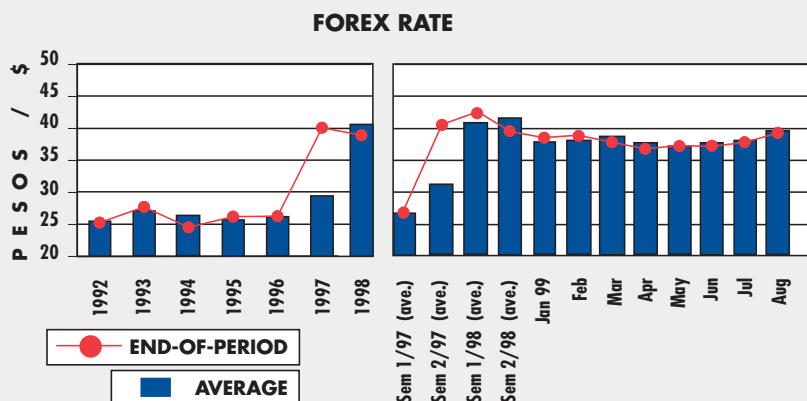
In June, 1999, President Estrada signed Republic Act 8747, the Philippines' Y2K Readiness Act, requiring firms and all agencies in seven key sectors to disclose their level of Y2K preparedness no later than September 30. Entities which do not make a disclosure to the Presidential Commission on Year 2000 Compliance are assumed to be non-compliant. Agency heads can be held administratively and criminally liable for damages caused by Y2K failures. The Commission has reported that as of August, the seven critical sectors (utilities, financial services, transportation, communications, health care, government services and manufacturing) were well on their way to compliance, led by the financial sector at 93% compliance.

Media attention has been increasing steadily in response to the Y2K Commission's public awareness campaign, but much of the attention has been negative in tone and in response to an erroneous report in *The Economist* citing the Philippines as the world's least Y2K-prepared country. The UN-sponsored International Y2K Cooperation Center, however, has come out in support of Philippine efforts to date, saying that the Philippines is as prepared as other Asian countries to face the millennium.

## Legislative Agenda

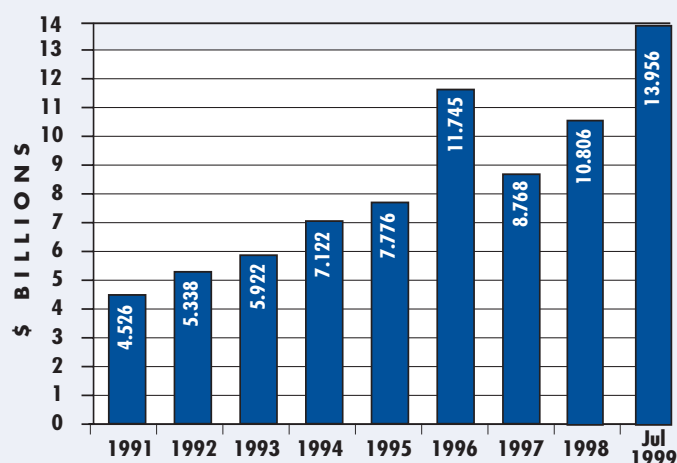
Many of the key reforms required to move the Philippine economy ahead require new or amended legislation. Unfortunately, such legislation has, for the most part and for a variety of reasons, not moved forward in the current Congress. Other than the 1999 budget, the only significant law enacted thus far has been the Clear Air Act.

With regard to trade and investment issues, first and foremost the Philippines needs to pass several laws relating to its WTO obligations, including laws on Plant Variety Protection and Customs modernization. Legislation to open the retail trade sector to foreign investment may be passed soon, but the required capital investments may be set so high as to discourage the introduction of any real competition in the sector.



\*End-of-period data refers to average foreign exchange rate on last trading day of indicated period.

## INTERNATIONAL RESERVES



With regard to banking and finance, amendments to the General Banking Act and legislation improving regulation and supervision of financial markets are pending in Congress. Legislation to overhaul the structure of the electric power sector has also been around for a few years, but appears to be nearing completion. It is worth noting that passage of some of this legislation will meet condition for the release of several hundred million dollars of multilateral development bank loans. It is imperative that the administration and legislature work together to ensure these key reforms move forward quickly.

## Challenges and Prospects

Given the strong performance in the first half of 1999, and barring unforeseen weather disturbances in the second half, we believe Philippine GDP will grow at up to 3.1% for the full year. Much of this growth, however, will come from the recovery of the agricultural sector. To move into a period of broad, sustained and stable growth, the Philippines must stick to and expand market-based reforms, decisively address structural problems, and open its markets more broadly to trade and foreign investment.

The most serious challenge in the short- to medium-term will be for the government to restore fiscal stability. Revenues perennially suffer from weak tax administration and collection. Taxes collected in the Philippines as a share of GDP are lower than in most other ASEAN nations. A bloated and inefficient bureaucracy delivers essential services poorly. Nearly half of the national government's budget goes to personnel-related expenses, after transfers to local governments and government owned corporations. Another 20% goes to debt service. This leaves little cash for much needed infrastructure improvements, which are often poorly managed and over budget. An improved fiscal regime would provide more funds for these essential projects, while also giving the government more flexibility in managing interest rates.

On trade, the tasks for the Philippines are clear. Moves to fulfill ASEAN, APEC and WTO commitments need to be completed on schedule, including the lowering of tariffs. In today's rapidly globalizing economy, the Philippine government needs to honestly assess the country's attractiveness as an investment location. Draws such as a well-educated workforce are being offset by negative factors such as inadequate infrastructure, the high costs of doing business (including power and transport costs), an inefficient (and sometimes corrupt) bureaucracy and a capricious legal system. To address these issues, the government must, among other things, establish a stable policy regime and continue with market based reforms and trade liberalization.

Even the traditional lure of highly skilled English-speaking workers is under threat as English language skills have noticeably declined over the last twenty years. An improved employment situation could drain today's apparently inexhaustible supply of workers with adequate language skills. Fierce

competition from lower wage economies suggests that the government should focus on improving skills and education to ensure workers are prepared for higher-skill jobs. Some observers suggest a lack of government funding has already had a serious negative impact on primary and secondary education.

Despite its impressive growth thus far in 1999, agriculture remains in serious trouble. It absorbs fully 40% of employment, yet accounts for only 20% of output. This weakness hampers higher growth because agriculture is an inefficient supplier to industries. At the same time, the agricultural population, with its very low income, does not provide a strong consumer base to increase demand. Policies intended to protect farmers by restricting imports of agricultural commodities have resulted in the highest food costs in Southeast Asia, raising labor costs and reducing living standards. Philippine sugar prices are nearly twice the world level, yet the industry is unprofitable and its workers among the poorest Filipinos.

The Philippines remains vulnerable to balance of payments problems. Recent current account surpluses reflect weak demand for imports in a contracting economy. The Philippines has rarely posted current account surpluses, only during times when the economy was weak. As a result, a return to growth may mean a return to current account deficits. The Philippines learned the hard way that foreign borrowings cannot indefinitely finance domestic investment. Therefore, the government needs to find ways to improve export value added, widen the narrow export base, and attract more viable long-term finance, especially foreign direct investment.

The banking system has been stressed by the crisis but remains sound. The Bangko Sentral, however, needs to act quickly to address oversight weaknesses revealed by the regional downturn. In particular, oversight needs to be conducted in a risk-based framework. Greater disclosure and transparency needs to be required, and off-site supervision and monitoring needs to be implemented. Pending legislation, which would, among other things, lift restrictions on the frequency of bank examinations and allow adoption of Bank of International Settlement (BIS) standards, are steps in the right direction. Further, the habitually low savings rate in the Philippines leaves business short of the capital it needs to expand. Steps by the government to introduce small-denomination treasury instruments and to improve the tax regime on financial instruments will be helpful in addressing this problem. More can be done to strengthen and deepen local currency debt and equities markets, including the contractual savings sector (such as pension and insurance plans).

Finally, income distribution in the Philippines remains highly skewed. The National Statistics Office recently released the final results of its 1997 Family Income and Distribution Survey. The numbers reveal that the richest 30% of families receive two-thirds of all income, while the poorest 30% receive only 7.9%. (The 1988 survey had the richest 30% bringing home some 63.4% and the poorest 30% collecting 9.3%.) The survey also revealed that urban family incomes are, on average 2.43 times those of rural families, up from a ratio 2.13 times in 1988. The government needs to continue determined efforts to spread the benefits of economic growth more widely and equitably.

## PROJECTIONS FOR 1999: SELECTED INDICATORS

	1998 Actual	1999 Projections <sup>a</sup>
GDP Growth (Year-on-year, %)	(0.5)	2.7-3.1
GNP Growth (Year-on-year, %)	0.1	3.2-3.6
Average Year-on-Year Inflation (1994=100, in %)	9.7	7.3-7.8
Average 91-day T-bill rate (%)	15.3	10.5
Average Forex Rate (Pesos/\$)	40.89	39.00-39.50
Exports (\$ Billions)	29.50	33.8
Growth (Year-on-year, %)	16.9	14.5
Imports (\$ Billions)	29.52	31.3
Growth (Year-on-year, %)	(18.8)	6.0
Trade Bal. (\$ Billions)	(0.08)	2.5

<sup>a</sup>Embassy projections as of April 1999

Sources (1998 data): National Economic and Development Authority; Bangko Sentral ng Pilipinas

## PHILIPPINES: KEY ECONOMIC INDICATORS

(In Million USD, unless otherwise noted)

	1997	1998	1999 <sup>p</sup>	
<b>Domestic Economy</b>				
Population (millions)	71.8	73.5	75.2	
Population growth (%)	2.32	2.32	2.32	
GDP (current) a/	82,241	65,111	73,037	} annualized first sem. figures
GNP (current) a/	85,744	68,215	76,842	
Per Capita GDP, current dollars a/	1,145	886	971	
Real GDP (% change, yr.-on-yr.)	5.2	(0.5)	2.4	
Real GNP (% change, yr.-on-yr.)	5.3	0.1	2.9	Jan-Jun
Consumer Price Index (ave. % change, yr.-on-yr.) 1994=100	5.9	9.7	7.7	Jan-Aug
<b>Production, Employment, Fiscal Accts.</b>				
Labor force (millions) b/	30.4	31.1	32.1	Jan/Apr/Jun
Unemployment rate (%) b/	8.7	10.1	9.7	Jan/Apr/Jun
Industrial prod. (1985=100), % change yr.-on-yr.	6.1	(1.7)	(1.4)	Jan-Jun
Nat'l gov't budget surplus (deficit) a/	53	(1,222)	(1,579)	Jan-Jul
as % of GNP	0.1	(1.8)	(3.6)	Jan-Jun
Consolidated public sector surplus (deficit) a/	(816)	(1,973)	(1,674)	Jan-Jun
as % of GNP	(1.0)	(3.0)	(4.4)	Jan-Jun
<b>Interest Rates (%)</b>				
Average T-bill rate h/	13.30	16.30	10.95	Jan-Aug
Average bank loan rate c/	16.22	18.39	13.00	Jan-Jul
<b>Balance of Payments</b>				
Exports (FOB)	25,228	29,496	15,803	Jan-Jun
Growth (% , yr.-on-yr.)	22.8	16.9	13.6	Jan-Jun
Imports (FOB)	36,355	29,524	15,107	Jan-Jun
Growth (% , yr.-on-yr.)	14.0	(18.8)	(0.9)	Jan-Jun
Trade Balance	(11,127)	(28)	696	Jan-Jun
Current Account balance	(4,303)	1,294	1,879	Jan-May
as % of GNP	(5.1)	1.9	5.9	Jan-May
BOP surplus/(deficit)	(3,383)	1,346	2,761	Jan-Jul
Net foreign investment flows d/	762	1,672	914	Jan-May
<b>Foreign Debt, as of end of period e/</b>	45,433	47,817	47,636	Mar
Debt service paid	5,597	5,061	2,255	Jan-May
Debt service (% of exports of goods and services)	11.6	11.7	12.0	Jan-May
<b>BSP International Reserves</b>	8,768	10,806	13,956	Jul
<b>Exchange Rate (pesos/\$)</b>				
Average exchange rate	29.47	40.89	38.45	Jan-Aug
Closing exchange rate f/	40.12	39.14	39.70	Aug
<b>Foreign Direct Investment (BSP registrations) g/</b>				
Total (cumulative, since 1973)	8,420	9,305	10,586	June
U.S. (cumulative, since 1973)	2,479	2,722	2,771	June
U.S. share (%)	29.4	29.2	26.2	June
<b>U.S.-Philippine Trade (Phil. data)</b>				
Philippine exports to U.S., FOB	8,815	10,100	1,504	Jan-Jun
Growth (% , yr.-on-yr.)	26.5	14.6	3.4	Jan-Jun
Philippine imports from U.S., FOB	7,928	6,424	999	Jan-Jun
Growth (% , yr.-on-yr.)	34.1	(19.0)	(19.3)	Jan-Jun
Philippine trade balance with U.S.	887	3,767	505	Jan-Jun
U.S. share of Philippine imports (%)	21.8	21.8	21.5	Jan-Jun

a/ originally peso values, converted to USD; b/ average of quarterly surveys (Jan/Apr/Jul/Oct); c/ computed as the ratio of banks' actual interest income to outstanding loans (rather than quoted rates for a given period); d/ direct and portfolio; e/ since 1994, excludes "net due to" accounts of foreign commercial banks; f/ average on last trading day of indicated period; g/ principally exercised to enable forex purchase from the banking system for capital repatriation and profit remittances; h/ weighted average for all maturities; p/ preliminary

**Sources:** National Economic and Development Authority; Department of Finance; Bangko Sentral ng Pilipinas